

UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Pat Wood, III, Chairman;
William L. Massey, Linda Breathitt,
and Nora Mead Brownell.

Trans Alaska Pipeline System, *et al.*

Docket No. OR89-2-000, *et al.*

Exxon Company, U.S.A.

v.

Docket No. OR96-14-000

Amerada Hess Pipeline Corporation, *et al.*

Tesoro Alaska Petroleum Company

v.

Docket No. OR98-24-000

Amerada Hess Pipeline Corporation, *et al.*

ORDER ESTABLISHING CONSOLIDATED HEARINGS

(Issued November 7, 2001)

These proceedings on remands from the United States Court of Appeals of the District of Columbia Circuit in Exxon Company U.S.A. v. FERC (Exxon)¹ and Tesoro Alaska Petroleum Co. v. FERC (Tesoro)² involve the method of making monetary adjustments among shippers of Alaska North Slope (ANS) oil on the Trans Alaska Pipeline System (TAPS). The adjustments are necessary because of the differing qualities of oil streams that are injected into TAPS. The adjustments are made by a quality bank, which compensates shippers with petroleum of higher quality than the common stream (*i.e.*, those whose petroleum will increase the quality of the common stream), and charges shippers that tender petroleum of lower quality than the common stream. In this order the Commission directs a concurrent hearing with the Regulatory Commission of Alaska (RCA)³ on the remanded issues in both Exxon and Tesoro.

¹182 F.3d 30 (D.C. Cir. 1999).

²234 F.3d 1286 (D.C. Cir. 2000).

³RCA was formerly the Alaska Public Utilities Commission.

I Background

On TAPS, the Commission has jurisdiction over quality adjustments paid by or to interstate shippers, and the RCA has jurisdiction over quality adjustments paid by or to intrastate shippers. In the past the two commissions have considered TAPS quality bank issues concurrently. In 1984 the Commission approved a quality bank using the American Petroleum Institute (API) gravity methodology. This methodology puts a higher value on oils with a higher gravity. The main oil reservoir of Prudhoe Bay contains a large amount of natural gas in addition to the crude oil, and in 1986, producers constructed and put into operation a Central Gas Facility to process natural gas liquids (NGLs). These NGLs, which are blended in large quantities into Prudhoe Bay petroleum and shipped to market through TAPS, have an extremely high API gravity. As a result, when the TAPS owners made the semi-annual filing in 1989 to adjust the amount of the Quality Bank charges, protests were filed alleging that, because the NGLs do not have as high a value as that attributed to them by the gravity method, shippers with a higher percentage of NGLs in their petroleum streams were being overcompensated by the Quality Bank.

In 1993, the Commission held that a change in the existing gravity-based quality bank was required because the presence of substantial amounts of NGLs in some of the streams had skewed the relationship between the "gravity" of the stream and its value, and approved, as modified, a contested settlement, which used a distillation method for valuing the streams. Under that methodology the crude oil stream is separated into its component parts or "cuts," market values are assigned to each cut, and the value of a crude oil stream is determined by the relative weighting of the cuts.⁴

In OXY U.S.A., Inc. v. FERC (OXY)⁵ the Court affirmed the finding that a change in the methodology was required, and that no refunds were due, but remanded the valuation of the distillate and resid cuts. The distillate cut is the portion of the stream that evaporates between 350 and 650 degrees Fahrenheit. The residual, or "resid," cut consists of the portion of the petroleum stream remaining after distillation of all other cuts at lower boiling points. Following the Court's decision in OXY, Exxon Company, U.S.A. (Exxon) filed a complaint, OR96-14-000, challenging the distillation methodology. The Commission consolidated Exxon's complaint with the OXY remand proceedings, and set the matters for hearing. During the course of the consolidated proceedings, parties filed three different settlement proposals on the remanded issues, one

⁴Trans Alaska Pipeline System, 65 FERC ¶ 61,277 (1993).

⁵64 F.3d 679 (D.C. Cir. 1995) (OXY).

by nine parties (Nine Party Settlement), and separate, unilaterally-proposed settlements by Exxon and Tesoro Alaska Petroleum Company (Tesoro). The Nine-Party Settlement was certified as a contested settlement, and subsequently approved by the Commission as a satisfactory resolution only of the valuation issues on remand of OXY (the 1997 remand order).⁶ In addition, as part of the settlement, the Commission ordered that the changes required by the settlement take effect prospectively. The order did not resolve the Exxon complaint, which remained before the ALJ.

The Nine-Party Settlement was affirmed, in part, in Exxon. While rejecting most of the challenges to the settlement, the Court nonetheless held that the method of valuing resid did not bear a rational relationship to the actual value of resid. Also, the Court found the decision to apply the settlement prospectively to be an abuse of discretion because the equitable factors on which the Commission based its decision did not, in the Court's view, overcome the strong equitable presumption in favor of retroactivity that would make the parties whole. The Court therefore vacated those portions of the order and remanded for the Commission to reconsider those issues.⁷

While the appeal in Exxon was pending, the hearing on the Exxon complaint proceeded. After argument and briefing on the issues, the ALJ issued an initial decision terminating the proceeding on the grounds that the arguments raised in the testimony were resolved in the prior proceedings, and that there were no changed circumstances requiring a new Commission determination as to the reasonableness of the distillation methodology.⁸ Further, the ALJ found that the arguments raised by Tesoro, an intervenor in the complaint proceeding, were moot as a result of the dismissal of the complaint, but that Tesoro could file its own complaint challenging the lawfulness of the Quality Bank distillation methodology. Tesoro, following the ALJ's suggestion, filed its own complaint, OR98-24-000, alleging that the valuation of the naphtha and VGO cuts under the distillation methodology resulted in inaccurate relative values in violation of the law.

⁶81 FERC ¶ 61,139 (1997).

⁷The ROCA's similar decision was returned to it by the Alaska courts, at the ROCA's request, after the Exxon remand.

⁸Exxon Co., U.S.A. v. Amerada Hess Pipeline Corp., et al., 83 FERC ¶ 63,011 (1998).

On April 30, 1999, the Commission issued two orders dismissing both the Exxon and the Tesoro complaints.⁹ Exxon and Tesoro appealed. In Tesoro the Court reversed the Commission. The court concluded that Exxon and Tesoro had presented sufficient evidence of changed circumstances as to the continued reasonableness of the distillation methodology and the valuation of the naphtha and VGO cuts. The Court found that the Commission had not responded specifically to "objections that on their face appear legitimate," and thus remanded the case to the Commission for further proceedings.

On November 24, 1999, the TAPS Quality Bank Administrator (QBA) notified the Commission of a change in one of the published prices used to determine the value of the heavy distillate component (450°F - 650°F). Pursuant to the Quality Bank methodology, the price for heavy distillate on the West Coast is set at Platt's Oilgram Price Report (Platt's) reported figure for West Coast High Sulfur (0.5%) Waterborne Gasoil. Platt's announced that effective November 1, 1999, "Platt's will no longer assess US West Coast Waterborne Gasoil reflecting a sulfur content of 0.5% sulfur. On this date, Platt's will introduce Waterborne assessments for Gasoil reflecting a sulfur content of 0.05%."

All parties agreed on Platt's West Coast LA Pipeline LS No. 2 quote as being the proper proxy. There was disagreement as to the level of the sulfur processing adjustment necessary to bring the TAPS Heavy Distillate cut into line with the quoted price.

On February 9, 2000, the Commission issued an order which accepted Platt's West Coast LA Pipeline LS No. 2 (0.05%S) as the appropriate proxy, and referred the issue of the correct level of adjustment to a settlement judge.¹⁰ Consistent with Section III.G.5. of the TAPS tariff¹¹ the QBA was directed to continue to use the West Coast High Sulfur (0.5%) Waterborne Gasoil price until the final decision on the appropriate processing cost adjustment. However, the Commission added that the provision requiring continuation of

⁹Exxon Co., U.S.A. v. Amerada Hess Pipeline Corp., et al., 87 FERC ¶ 61,133 (1999), and Tesoro Alaska Petroleum Co. v. Amerada Hess Pipeline Corp., et al., 87 FERC ¶ 61,132 (1999).

¹⁰90 FERC ¶61,123 (2000).

¹¹That section provides that "For the period between the time that quotation of a product price is discontinued or the specifications or other basis for the quotation is radically altered and the time that the Commissions approve the use of a replacement product price, the Quality Bank Administrator shall calculate the unit value of the component in question by using the monthly average price for the last month for which a product price was available for such component."

the prior price obviously contemplated only a short period when that price would remain in effect since the Commission was required to act within 60 days of the notice by the QBA. Since in this case the final decision on the new price may not be issued until a longer period of time has elapsed, the Commission directed that the issue of whether the new price should be applied on a retroactive basis should be addressed in the proceeding before the settlement judge.¹²

II. Pending Matters

At issue in the Exxon remand is the valuation of the resid cut and the retroactive application of the modifications. On August 29, 2000, Eight Parties submitted an offer of settlement to resolve these issues, and the replacement product issue. On October 10, 2000, Exxon and Tesoro filed in opposition and submitted their own offer of settlement. Numerous comment and reply comments have been filed by both sides.

At issue in the Tesoro remand is the valuation of the naphtha and VGO cuts (Tesoro's complaint), and whether the distillation methodology is no longer just and reasonable (Exxon's complaint).

At issue in the replacement product proceeding is the level of the sulfur processing adjustment necessary to bring the TAPS Heavy Distillate cut into line with the quoted price.

RCA has similar pending proceedings: (1) the original quality bank case, which has not been fully resolved, RCA Dockets P-89-1, P89-2, and P94-4; (2) the Exxon complaint, RCA Docket P96-6; (3) the Tesoro complaint, RCA Docket P98-8; and (4) the pricing of the heavy distillate, RCA Docket P-99-12.

III. Discussion

In this order the Commission consolidates all the dockets, and directs a hearing on the remanded issues in both Exxon and Tesoro. The order also directs a hearing on the processing cost adjustment of the replacement product for the West Coast heavy distillate. The issues are discussed below.

A. The Resid Valuation

¹²Williams Alaska Petroleum, Inc. filed a petition to review the February 9 order, but the Court of Appeals dismissed the appeal as premature.

The resid cut consists of the portion of the petroleum stream remaining after distillation of all other cuts at lower boiling points. In the 1997 remand order, the Commission rolled the light resid into the Vacuum Gas Oil ("VGO") cut, by raising the top end of that cut to 1050 degrees, eliminating the light resid cut.. Exxon affirmed the Commission's action.

For heavy resid (1050+) the Commission found that there was no active market for resid, and opted to price resid based on its value as a coker feedstock. The calculated value of resid as a coker feedstock was derived using the PIMS model¹³ by looking at the finished products into which the resid is made during the coking process and determining the values of those finished products. Adjustments are made to the value of the finished products because they are derived from resid, and are not being derived from a straight run. The values are further adjusted to reflect the capital and operating costs of the coking facilities. The coker feedstock values over a five-year period were then compared to the market price of FO-380 during this same period. The Commission accepted the adjustment of 4.5 cents/gal to the market price of FO-380 as within that range of values. The Commission added Gulf Coast 3 percent sulfur No. 6 fuel oil as a Gulf Coast reference product, with the same 4.5 cents per gallon processing cost.

In Exxon the Court stated that while there was substantial record evidence supporting the intermediate steps the Commission took in determining the value of resid--i.e., its determinations that no active market exists, that resid is best valued as a coker feedstock rather than as a blender for fuel oil, the last step, that since FO-380 and No. 6 fuel oil are the actively-traded products in the relevant markets most similar in physical characteristics to resid and should be used as a proxy for resid, did not logically follow from these premises.

The Court noted that the 4.5 cents adjustment, while it falls within the range of the observed variation, does no more than that. The Court stated that there is no evidence that the prices of the proxy products were more than coincidentally related to the value of resid as a coker feed-stock. Moreover, the calculated value of resid using the PIMS model did not even vary consistently with the price of FO-380. The Court, while recognizing that the Commission was concerned that more complex systems might give the appearance that the price of resid was open to manipulation, did not relieve the Commission of the requirement that the chosen proxy bear a rational relationship to the actual market value of resid. Accordingly, the Court remanded so the Commission could determine a logical method for deriving a value for resid.

¹³The PIMS system is a standardized petroleum industry modeling system used to calculate refinery needs and outputs.

On remand, we direct that a hearing be held to determine the appropriate method for valuing the resid cut. We note, as did the Court in Exxon, that since there is no published market price for resid, its valuation presents a vexing problem. Nevertheless, we direct that the parties submit proposals for valuing heavy resid with adequate supporting evidence, and that the Administrative Law Judge make a determination based on the record. Any proposals based on the value of resid as a coker feedstock using the market value of the finished products into which the resid is processed must be supported by evidence of the processing costs necessary to turn resid into such finished products. Proposals based on the value of resid as a coker feedstock should also consider administrative ease, e.g., limiting the number of calculations the Quality Bank Administrator must make in order to derive the value of resid. Proposals using a proxy must satisfy the Court's concern that the proxy bear a rational relationship to the actual value of resid.

B. The Tesoro Complaint

In Tesoro the Court held that the Commission must respond to Tesoro's challenge to the valuation of the VGO and Naptha cuts. As more fully explained, infra, the hearing should include this issue.

C. The Implementation Date

In the 1997 remand order, the Commission concluded that the equitable approach would be to implement the settlement on a prospective basis, as all other TAPS settlements had been implemented. This was consistent with the 1993 Order applying the new rates prospectively, which was affirmed in OXY.

In Exxon the Court agreed that the Commission does have a measure of discretion in determining when and if a rate should apply retroactively. However, it concluded that the equitable factors on which the Commission based its decision¹⁴ did not overcome the

¹⁴The Court stated that the Commission had relied on the following factors: (1) that parties supported the Nine Party Settlement only if it were implemented prospectively; (2) that all prior TAPS cases resolved by settlements have been on a prospective basis; (3) that the changes adopted by the Settlement Order only modify limited aspects of the distillation methodology put in place in 1993; and (4) that the TAPS Quality Bank is sui generis. 81 FERC at 62,467. Moreover, the Court pointed out that factor number one was not mentioned in the Commission's order, but only in the
(continued...)

strong equitable presumption in favor of retroactivity which would make the parties whole. It found that the factors the Commission relied on had no bearing on the decision, and did not explain the decision not to make whole the parties that were clearly injured by undervaluation. Given the strong presumption in favor of making injured parties whole and the incentive that this creates for the parties to litigate regarding past errors and for the agency to correct those errors, the Court concluded there was not a sufficient reason not to make the revaluation and concomitant Quality Bank adjustments retroactive to 1993, when the distillation method was adopted. Accordingly, the issue of the effective date of the new valuation method was remanded for action consistent with the Court's opinion.

Exxon recognizes that the remedy phase permits the Commission to determine the effective date, if there is a basis for not requiring full retroactive effect. In Exxon, the Court was concerned that the settling parties might have chosen prospective application of the settlement "to divvy up a windfall at the expense of the contesting parties."¹⁵ The "windfall" referred to would be the inappropriate valuation of the distillate and resid cuts from the 1993 date the distillation method was adopted until the revised valuation of these cuts was implemented. Given the court's emphasis upon the equitable factors, we shall permit parties to introduce evidence why they maintain the revised valuations for the distillate and resid cuts should be adopted on a prospective basis, because it would be inequitable to require retroactive application of the revised valuation.

D. The Replacement Product Issue

At issue in the replacement product proceeding is the level of the sulfur processing adjustment necessary to bring the TAPS Heavy Distillate cut into line with the quoted price. Although the Commission referred the matter to a settlement judge, on August 7, 2000, the Chief Judge returned the replacement product proceeding to the Commission. The Commission concludes that this matter should also be set for hearing, and consolidated with the remand issues.

E. The Hearing Procedure

After the Court remand in Tesoro, the two sides submitted different proposals on how to proceed. On March 8, 2001, Exxon and Tesoro filed a proposal that the

¹⁴(...continued)
brief to the Court.

¹⁵182 F.3d at 50. The Court thus held that making the settlement conditional upon its being prospective could not be a factor that the Commission could rely upon.

proceeding be consolidated and that, after the filing of some additional testimony, a single hearing be held to resolve the interrelated issues. They contended that both of the Contested Settlement Offers now pending in Docket Nos. OR89-2-007 propose coker feedstock valuation methodologies for the Resid cut that necessarily make use of the component valuations for VGO and Naphtha. Thus, they argued, resolution of the remanded issues regarding Naphtha and VGO valuations in Docket No. OR98-24-000 will have a direct impact on the valuation of the Resid cut which is at issue in Docket No. OR98-2-007. Valuation of the Heavy Distillate cut is also at issue in Docket Nos. OR89-2-007. Finally, they contend that the issues of whether the distillation methodology, when applied as a whole, produces unjust and unreasonable results, and should be replaced by another methodology – the issues in Docket Nos. OR96-14-000, are obviously intertwined with consideration of what valuations to adopt for the Resid, Heavy Distillate, Naphtha and VGO cuts of the distillation methodology. Accordingly, they argue, all matters should be consolidated for hearing.

On March 23, 2001, the Seven Parties¹⁶ responded to that proposal with their own proposal which involves a three step procedure:

Step 1: The Commission should first act upon the Seven Parties' Contested Settlement which is currently awaiting action by the Commission, which resolves Heavy Distillate cut valuations.

Step II: The Tesoro complaint should be addressed next because it seeks to change the valuation of two of the distillation methodology cuts that were not challenged as part of the *Oxy* appeal process. There is substantial record in place on the valuation of these cuts and only supplementary filings would be required these issues will be ripe for decision on a paper record.

Step III: As soon as the valuation of all the distillation costs has been finalized, the Exxon challenge to the entire methodology would be addressed. The Commission would receive testimony and authorize extensive discovery and cross-examination regarding whether the revised distillation methodology – with the new cut values for Resid, West Coast Heavy Distillate, Naphtha and VGO that will have been approved already by

¹⁶The number of parties on one side has changed from nine to eight to seven, as certain parties transferred their interest to others in the group. The Seven Parties now consist of BP Exploration (Alaska) Inc., OXY USA Inc., Petro Star Inc., Phillips Alaska, Inc., the State of Alaska, Union Oil Company of California, and Williams Alaska Petroleum Inc.

the Commissions in Steps 1 and 2 – produces overall results that are unjust, unreasonable and discriminatory and, therefore, must either be further modified or replaced with a different methodology.¹⁷

In light of our decision that a hearing is required on the valuation issues, we find merit in the Exxon-Tesoro proposal. Accordingly, we shall consolidate the proceedings, and set all matters for hearing. This includes the Resid cut and West Coast Heavy Distillate cut valuation issues in Docket No. OR89-2-007, the West Coast Naphtha and VGO cut valuations raised by Tesoro, and finally, with the above issues determined, whether the distillation methodology, produces unjust and unreasonable results, and whether a different methodology produces just and reasonable results. Further, the ALJ should determine the implementation date for any changes in the existing methodology.

With the agreement of the RCA, we direct that concurrent hearings be held with the RCA as has been done in prior TAPS evidentiary hearings. The procedures adopted in the initial TAPS quality bank order issued on December 19, 1989,¹⁸ which are consistent with the requirements of section 385.1305 of the Commission's regulations,¹⁹ will apply to these consolidated proceedings. However, the assigned ALJs will be permitted to confer on matters of substance as well as procedure, and should attempt to agree on a joint decision.

The Commission orders:

(A) The proceedings in Docket Nos. OR89-2-000, OR96-14-000, and OR98-24-000 are consolidated as discussed in the body of this order.

(B) The Chief Administrative Law Judge shall designate a Presiding Administrative Law Judge for the purpose of conducting concurrent hearings with a presiding officer of the RCA in accordance with the discussion in the body of this order.

By the Commission.

(S E A L)

¹⁷On April 9, April 20, and May 3, 2001, the parties filed additional pleadings regarding their proposals.

¹⁸See Trans Alaska Pipeline System, 49 FERC ¶ 61,349 (1989).

¹⁹18 C.F.R. § 385.1305 (2001).

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David P. Boergers,
Secretary.